History as a Guide

September 2021

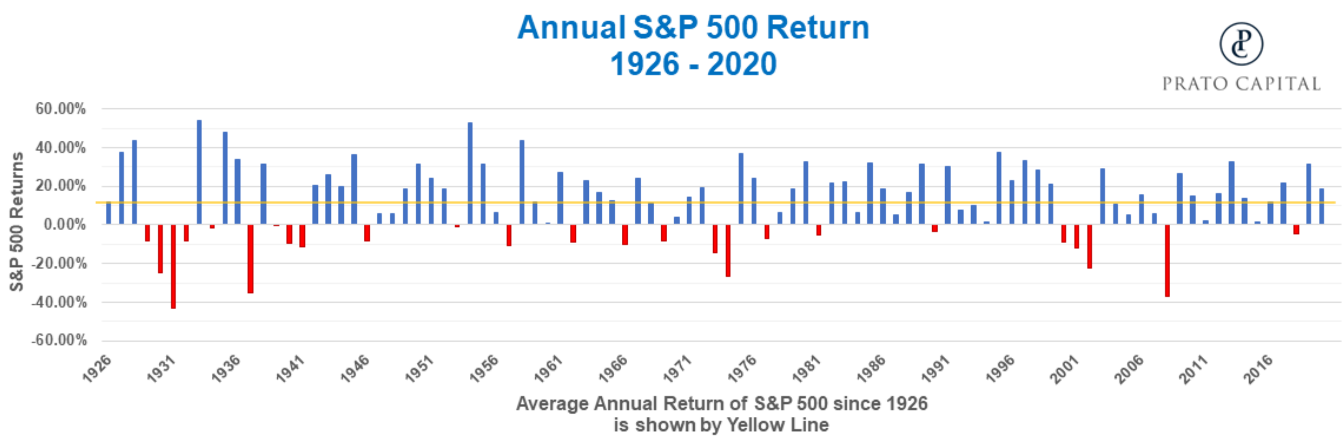
In many of our newsletters, blogs, emails, and social media posts the phrase "Using history as a guide" comes up. What does this really mean? Can we look back and still look ahead?

Why use "history as a guide"?

At Prato Capital, we believe looking back further than the latest quarterly and annual returns can provide some insight into how markets and ultimately client portfolios may react to unexpected future events like market downturns, a financial crisis, elections, or even wars.

Market data for a broad-based stock index in the United States became reliable around 1926 with what is now called the S&P 500. Over this period, the index has returned an average of about 10% annually. Figure 1 below shows the historical annual returns, and the horizontal yellow line on the chart indicates that 10% average return over the past 95 years. This range of dates includes past events such as World War II and the Korean and Vietnam Wars, the assignation of President Kennedy and the resignation of President Nixon, high inflation through the 1970's and multiple financial crises, a depression and multiple recessions, terrorist attacks and even a pandemic.

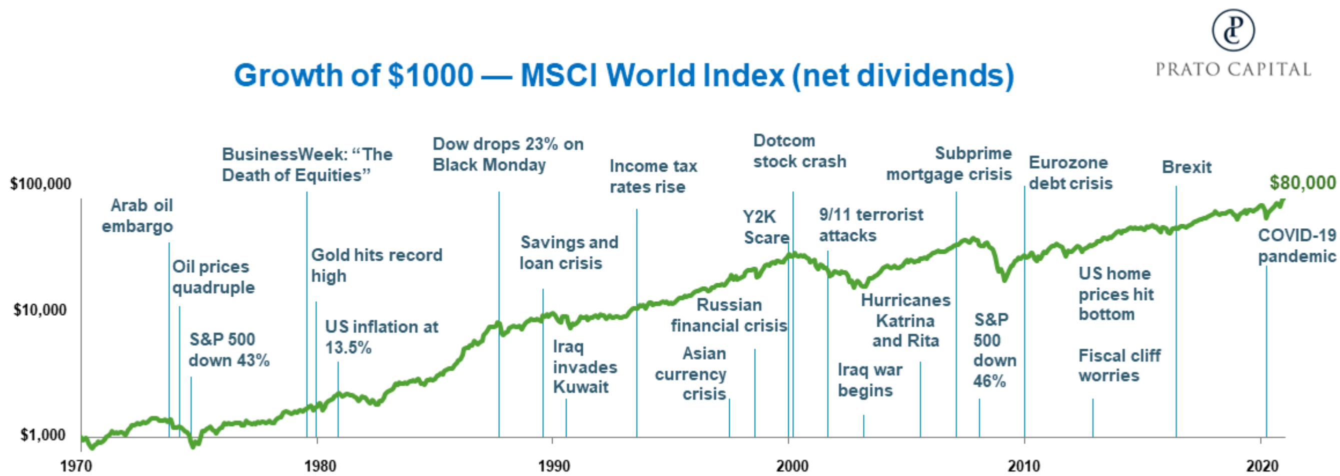
Figure 1:



Although the average from 1928 is 10%, the returns from year to year do vary significantly from this average. But, a quick look at the chart above shows that many more years resulted in a positive gain in the S&P 500, and some of the gains were quite substantial. Even 2020 which included a short bear market during the pandemic, resulted in an above-average gain of the S&P 500 by the end of the year.

The S&P 500 is one of the major stock indices in the United States. At Prato Capital, we believe a diversified portfolio should also include international stocks and a major international index is the MSCI World Index. This is a broad index that includes stock data from 23 developed economies. In Figure 2 below, the MSCI World Index is shown with some financial events over the past 50 years.

Figure 2: Markets Have Rewarded Discipline



The chart above shows how just $1,000 can grow to $80,000 when kept invested through many events that were portrayed as market changing. The path to growth in the financial markets is not always a straight line and can be stressful at times, but history has shown that staying invested can reward investors over time.

When we look at using history as a guide, the view of how markets reacted both short and long term to previous events can provide many insights on what to expect when the unexpected happens.

Investment Strategy or Investment Fad

"There's one robust new idea in finance that has investment implications maybe every 10 or 15 years, but there's a marketing idea every week." – Economist Eugene Fama, Nobel Laureate

Long-term investors are best served by having a robust investment plan that they can stick with through the entirety of their financial life. Sometimes it can be difficult to differentiate a valid investment strategy from one of the many investment fads that come and go on a regular basis. When using history as a guide, we can see more clearly how some previous investment 'strategies' have fared.

Many so-called investment strategies over recent decades have not lasted or fared well. In our March 2019 newsletter, we looked at past investment fads like the Nifty Fifty, Asian Tigers, BRIC and dot com stocks. More recently and discussed in multiple blog posts this year, we have seen other investment 'strategies' involve SPAC's, NFT's, cryptocurrencies, and other concentrated exchange-traded funds with catchy ticker symbols.

Many of these new investing ideas may initially seem appealing, even make economic sense, and give investors a feeling that they know something that the rest of the investment world has missed. Unfortunately for these investors, if the information is in the news or online, it has already been priced into the markets. The markets are very efficient and price according to the latest news very quickly.

Our March 2019 newsletter titled “Déjà vu All Over Again” asked three questions investors should consider before investing in a new strategy and these questions are still applicable today:

1. What is this strategy claiming to provide that is not already in my portfolio?
2. If it is not in my portfolio, can I reasonably expect that including it or focusing on it will increase expected returns, reduce expected volatility, or help me achieve my investment goal?
3. Am I comfortable with the range of potential outcomes?

At Prato Capital, we often refer to our clients achieving the financial goals laid out in their Financial Life Plan (FLP). When any new investment is considered, the answers to the questions above often brings the conversation back to their FLP and what they are trying to achieve with their portfolios. Is this new investment the right choice for them and how will this investment enhance the chances of reaching their financial goals? With the hope of easy money, increased risk and volatility are often overlooked when any of the latest new investment fads are considered.

As part of our clients FLP, a balanced and diversified portfolio based on their individual risk tolerance helps them reach their financial goals with reduced risk and volatility when compared to the latest investment fad.

Conclusion

Looking back further than the latest quarterly and annual performance can provide many insights into how markets can behave in the future. When using history as a guide, we see the equity markets have remained very resilient through many political and financial events over the long-term.

History hasn’t always been kind to many so-called investment strategies. Increased risk and volatility most often are the result without the returns shown by the major stock indices over the long-term. There may be a better way with a balanced and diversified portfolio for investors do well over the long-term. It may not have a flashy name or make financial headlines but an investment strategy based on academic and Nobel Prize winning research sounds good to us.

“The memory of the financial community is proverbially and distressingly short.” – Benjamin Graham.